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PROPOSED REPEAL OF TAX EXEMPTION
FOR ALLOWANCES PAID TO
OVERSEAS FEDERAL EMPLOYEES

Background

TREASURY
"PRO"

It is a long-established principle of U.S. tax policy that U.S. citizens are subject to tax on worldwide income regardless of where they reside. To avoid double taxation of U.S. citizens who live in foreign countries, the U.S. permits them to credit foreign income taxes against their U.S. tax liability on foreign source income.

There are three major exceptions to the rule of worldwide taxation of citizens. One, introduced in 1926, is Internal Revenue Code section 911 which provides an exclusion from gross income for \$20,000 or \$25,000 of income earned abroad by U.S. citizens who are bona fide residents of a foreign country or who remain outside the United States for 17 out of 18 months.

The second exception, introduced in 1943, is Code section 912 which excludes from gross income certain allowances paid to civilian employees of the Federal Government who work outside the United States (or in Alaska, Hawaii or at the U.N. in New York). Although as originally enacted the section only applied to cost of living and post allowances, its coverage has been expanded over the years to apply to housing and educational allowances.

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The third exception is various exclusions for certain compensation and allowances paid to military personnel. The compensation exclusions are statutory and make tax-exempt certain combat pay, mustering-out payments and reduced retirement pay (Code sections 112, 113 and 122). The allowance exclusions, however, derive from a 1925 Court of Claims decision that, under the language of the 1921 revenue act and because of military regulations, the value of free military housing and cash payments in lieu of government-supplied housing were not compensation or income to the recipient. On the basis of that decision, the Internal Revenue Service has ruled that allowances for subsistence, commutation of or basic allowance for quarters, family separation, cost-of-living, transportation between posts, meals and uniforms are not includible in income. In general, the military allowances are similar in type, although somewhat less in amount, to allowances paid civilian personnel overseas.

In May, 1974, the House Ways and Means Committee reviewed existing United States taxation of foreign income and activities. One result of this review was a decision

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by the Committee to repeal section 911.* However, to allow present beneficiaries of the section to adjust to its repeal, the exclusion was to be phased-out on a pro rata basis over three years.

The Treasury Department did not oppose repeal but suggested that some alternative relief was justified to recognize such things as the additional cost of foreign residence resulting from inability to use services or facilities provided by governmental units in the United States. In light of this consideration, the Committee adopted a special deduction of up to \$100 per month per dependent for educational expenses incurred abroad and provided that the value of municipal-type facilities

* It was felt the present section operates indiscriminately and inequitably, providing no benefits to those citizens living in countries with tax rates equalling or exceeding the U.S. tax rate and double benefits to those citizens who are exempt from foreign taxation in any event, e.g., those entitled to treaty protection from foreign taxation. The Committee was not convinced that section 911 was justified by the argument that living abroad is more expensive than living in the United States. While this may be true in some instances, it was felt that in other instances the cost of living abroad is less than in the United States. Similarly, while there are significant variations in cost of living in the regions within the United States, the tax laws contain no exclusion recognizing these variations. To the extent there are additional costs in locating employees abroad, those costs should be borne by the employer, and not subsidized by the Federal government.

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supplied by an employer to foreign located employees should not be income to those employees.

At the time the Committee was considering repeal of section 911, it became concerned that private citizens working abroad not be treated unfairly in comparison with Government employees* working outside the United States. The Committee considered and rejected permitting private sector employees to exclude the same allowances excludable for government employees. A basic problem with that approach was that it did not meet the fundamental objection that it is not appropriate for the U.S. Government to subsidize private U.S. citizens working overseas.

Moreover, the Government allowances are not readily transferred to the private sector. For example, State Department allowances, which serve as guidelines for many other agencies, provide for completely free housing, not just for the excess of foreign over U.S. costs. Either government owned housing is provided at no cost to the employee or a tax free cash allowance is given to cover the cost of rental. For Government employees the cost of living

* The Committee only considered the allowance situation of civilian personnel overseas, and did not consider the tax-exempt status of military allowances.

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abroad is also affected by access to tax free imports in special commissaries, which varies from post to post. The allowances themselves vary widely and arbitrarily from one agency to another.

Since there appeared no equitable manner of treating public and private employees equally other than elimination of the exclusionary provisions and since the Committee felt the original justification for section 912 was no longer relevant, repeal of section 912 was adopted.¹ As with section 911 repeal, the allowance exclusion was to be phased-out pro rata over a three year period.²

Reasons for Repealing Section 912

1. Section 912 is Anachronistic.

Section 912 was introduced in 1943 as a wartime necessity because rapidly rising living costs were imposing a heavy financial burden on overseas State Department

¹ It should be noted that repeal of section 912 would have no effect on allowances which are reimbursements for deductible expenses, e.g., travel costs or moving expenses. Repeal would only result in increased taxation of allowances which cover non-deductible, personal expenses, e.g., housing.

² The repeal of sections 911 and 912 was included in H.R. 17488. This bill was reported by the Ways and Means Committee, but was not considered by the House before the 93rd Congress ended.

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personnel. Since it was felt these individuals were vital to the war effort and since the State Department could not increase its appropriation, the tax exclusion was enacted. The wartime emergency has ended and appropriations should be increased to reflect additional allowance requirements.

2. Section 912 Distorts the Progressive Tax System.

An exclusion from gross income is inconsistent with the basic principle of our system, i.e., the greater the taxable income, the higher the marginal and average tax rates. For example, a single Foreign Service officer who earns \$25,000 in salary, \$5,000 in interest and dividends, and \$10,000 in State Department allowances would in fact have \$40,000 in "income" as that concept is used in U.S. tax law. If the allowances are excludable and the officer takes only one exemption and standard deduction of \$2,000, the marginal tax rate on his last dollar of actual taxable income (\$27,250) would be 45% and the average tax rate on each dollar of real taxable income (\$37,250) would be 22%. However, if the allowances were taxable, his marginal tax rate would rise to 50% and his average tax rate to 35%. In other words, not only is he escaping taxation on \$10,000 of income, but his other income is also being taxed at a

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lesser rate than is applicable to other similarly situated taxpayers who are not entitled to section 912 benefits.

Additionally, the value of the tax benefit under section 912 is dependent upon the recipient's personal tax status. Those recipients which would pay no tax in any event, i.e., because of sufficient offsetting deductions, receive no tax benefit. For those recipients who do pay taxes, the value increases as the recipient's tax rate rises so that those in the highest income categories realize the greatest benefits.

3. Excludable allowances create inequities in the tax status of similarly situated overseas employees.

One argument to justify overseas allowances is that they are not actually income to the recipient but instead are reimbursements for expenses which he would not otherwise incur. In other words, these expenses should be viewed as deductible employee business expenses. However, the recent GAO study* points out the often inconsistent manner in which allowances are granted by the various Federal

* Comptroller General of the United States, "Fundamental Changes Needed to Achieve A Uniform Government-Wide Overseas Benefits and Allowances System for U.S. Employees," September 9, 1974.

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agencies. Some agencies, for example, reimburse employees for travel expenses for rest and recuperation. Other agencies do not. If such costs are to be viewed as deductions, they should be deductible by all overseas personnel, whether or not they are reimbursed by the particular agency. Section 912 augments the inconsistency noted by the GAO since it only benefits those employees who incur reimbursable expenses.

If the tax laws are to affect the status of overseas personnel, it would be more logical to permit deductibility of actual qualifying expenses paid by the employee regardless of whether they were reimbursable by the employing agency. This would result in equitable and consistent tax treatment for all similarly situated employees. It would also be desirable from a tax policy perspective since it would distinguish between the compensatory and incentive aspects of existing allowances. The compensatory portion would not be taxed since there would be a corresponding deduction. However, the incentive portion which is more analogous to salary would increase taxable income since they would be no offsetting deduction.

4. Section 912 disguises the true cost of sending personnel overseas.

In order to assess accurately the benefits of a particular governmental program or activity, obviously the

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actual costs must be known. When a program or activity is in part or in whole financed by indirect subsidization through the tax law, this assessment becomes more difficult. As noted above, section 912 was in fact originally enacted to avoid having to increase the State Department's appropriation request. While it is arguable that a notation in the budgets of agencies which benefit from tax subsidies could reflect the tax cost, this would be a more cumbersome and inexact manner of presenting this cost.

5. If only section 911 is repealed, section 912 creates inequitable tax treatment between governmental and non-governmental personnel abroad.

When considering sections 911 and 912, the Ways and Means Committee concluded the civilian employees of the Federal government and private citizens working overseas should be treated equally under the tax laws. The ultimate consequence of this conclusion was the Committee's recommendation to repeal both sections. Since a tax benefit to one group of taxpayers inevitably brings pressure for extending those benefits to taxpayers who believe they are similarly situated, repeal of only section 911 would be viewed as discriminatory against non-governmental foreign personnel. In addition, the existence of tax benefits to particular governmental employees creates pressure to

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extend those benefits to other governmental employees, e.g., a Senator has inquired of the Treasury Department whether section 912 benefits should be extended to VISTA volunteers. While it is arguable that overseas governmental employees are peculiarly important to the national interest to justify special treatment, this argument is primarily a subjective conclusion which will not be particularly persuasive to other governmental and non-governmental employees who are not benefitted.

Reasons for Retaining Section 912

1. Section 912 creates equity between government employees at home and abroad.

To the extent that the allowances cover increased living expenses, they enable the overseas employee to live at the same standard as he would if he were living in the U.S. If the allowances are taxed, the overseas employee will have to live at a lower standard. Thus section 912 creates equity between the overseas employee and the U.S. employee.

This argument of course has no application to the extent that the allowances are in excess of increased living costs. It also does not apply if the allowances are increased to take into account the fact that they are taxable.

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2. Section 912 creates equity between civilian and military personnel of the Federal government.

If section 912 were repealed and the tax-exempt status of military allowances were unchanged, civilian government employees overseas would feel disadvantaged. Here again, however, this argument could be obviated by raising civilian allowances to reflect the tax benefit loss, and/or eliminating the tax-exempt status of military allowances.

3. Repeal will produce no net effect since allowances will be raised to compensate for loss of tax-exempt status, but will cause interim discontent among overseas employees and confusion in the existing allowance systems.

Since section 912 affects only Government employees, making the allowances taxable may be challenged as a mere bookkeeping item: more revenue will be collected, but the allowances themselves will have to be increased to offset the cost of the tax. Also, until allowances are increased, existing overseas personnel will be dissatisfied and potential overseas employees discouraged from accepting foreign assignments. Furthermore, revising the existing allowance system will be complex and time-consuming.

The three-year phase-out is intended to allow those adjustments to be made before complete repeal is effected and to mitigate the immediate consequences to existing beneficiaries of the section. However, even if present

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allowances are increased to reflect their taxable nature, such increases presumably will not reflect each recipient's particular tax status. In other words, the increase would be based upon the tax cost attributable to the recipient's Government salary plus the taxable allowances and not upon the tax cost resulting from his Government salary and allowances plus his outside income. Thus recipients of the allowances with non-salary income will not be unduly benefitted. In addition, as noted above, taxing the allowances will permit a more accurate assessment of the true costs of sending personnel overseas.